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Investment companies industry developments, 1992; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Investment Companies Industry Developments—1992

Update to AICPA Audit and Accounting Guide *Audits of Investment Companies*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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1 2 3 4 5 6 7 8 9 0 AAG 9 9 8 7 6 5 4 3 2

Table of Contents

Investment Companies Industry Developments—1992

Industry and Economic Developments

Since *Investment Companies Industry Developments—1991* was published, investment companies have continued to face challenges relating to competition, internationalization, and federal and foreign income taxes. Although the overall economy has continued its extended struggle to emerge from a recession, the mutual fund industry, as a whole, has continued to prosper. Total assets of mutual funds increased by $192 billion during the first eight months of 1992. The Federal Reserve Board's successive cuts in interest rates caused a downward spiral in interest rates that stimulated increased investments in mutual funds. Generally, investors in mutual funds believe that a respectable return can be earned on their investments without subjecting that investment to significant risk. However, mutual funds that invest in securities of foreign issuers and derivative instruments, such as financial futures, forward foreign-currency contracts, financial indexes, and options on futures, continued to be popular with some investors.

Competition

Competition among investment companies and between investment companies and depository institutions (banks and savings institutions) has continued to grow in 1992. Investment transactions, capital structures, and fund organizations have become increasingly complex as funds compete for additional market share. In addition to competition among funds, banks are challenging mutual funds for the investors' dollar. Banks now manage more than $120 billion in mutual fund assets in 680 funds, more than double the level of a few years ago. Banks have seen their share of the savings dollar plunge from 84 percent to 58 percent over the past seven years as depositors seek higher returns. The auditor should be aware that increased competition may heighten pressures on fund managers to improve financial returns, and that this may lead to more aggressive investments and accounting and reporting techniques.

Internationalization

Total assets of U.S. funds invested in foreign equities and bonds increased from $25.9 billion as of December 31, 1990, to $44.1 billion as of

December 31, 1991, as fund managers recognized the attractive markets overseas. Even greater opportunities for U.S. based fund managers to operate in the international arena are expected to become available as reciprocal sales agreements are developed and as legal impediments are eliminated.

Auditors of financial statements of mutual funds that invest in foreign securities should consider the implications that holdings of such securities have on audit risk. Specifically, valuation of such securities may present management with unique and difficult problems. Auditors' tests of such valuations may require special consideration. In particular, auditors should carefully evaluate whether management has considered all factors relevant to the valuation of such securities.

When the values of foreign securities are determined "in good faith" by boards of directors, auditors may find that they need to assess more carefully management's procedures for valuing them. (See "Audit Issues" section for further discussion of valuing securities.)

Economic conditions in the jurisdictions in which funds invest may also affect the auditor's assessment of risk inherent in the audit. Factors that auditors should consider include local rates of inflation, government stability, and local tax rules. Auditors should consider whether indicators such as those described above create, intensify, or mitigate audit risk.

Taxes

It is important for the auditor to determine compliance with the tax rules that have a direct and material effect on the determination of mutual funds' financial statement amounts so that they are able to assess whether the income tax and excise tax provisions should be recorded in the financial statements. Special tax rules outlined in subchapter M of the Internal Revenue Code of 1986 ("the Code"), as amended, specify requirements relating to minimum distributions of earnings, qualifying income, diversification of investments, and sales of securities held less than three months.

Additionally, rules promulgated under sections 988 and 1256 of the Code require special tax treatments for securities denominated in foreign currencies and for forward currency contracts and financial futures contracts. Such rules may affect the character of income and therefore the distributions that funds may be required to make. As such, violations of these tax rules may have a direct and material effect on the determination of amounts in funds' financial statements. Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients,* requires that audits be designed to provide reasonable assurance of detecting misstatements that result from illegal acts that have a direct and material effect on the determination of financial statement amounts.

Regulatory and Legislative Developments

Amendments to National Association of Securities Dealers' Rules

The Securities and Exchange Commission (SEC) approved amendments to the National Association of Securities Dealers' (NASD's) *Rules of Fair Practice* (Release No. 34-30897, July 7, 1992) that would limit asset-based and deferred sales charges and extend the applicability of the NASD's rules to mutual funds with contingent deferred sales charges and rule 12b-1 plans. The new *Rules of Fair Practice* will become effective on July 7, 1993, and may affect the revenues of mutual funds managers and distributors.

SEC Study of the Investment Company Act of 1940

In May 1992, the SEC issued a comprehensive study of the Investment Company Act of 1940. Although the report does not address accounting issues directly, it includes a number of recommendations that are likely to affect the operations of mutual funds. For example, one of the study's recommendations has resulted in a proposal (Release No. ICC-18869) that would authorize closed-end investment companies to repurchase their shares on a regular periodic basis and allow open-end investment companies and registered separate accounts to repurchase their shares less often than daily through two new types of funds:

1. *Extended payment funds,* which would also include certain insurance company separate accounts, would permit continuous redemption of shares at net asset values, though payment could be delayed for up to thirty days.
2. *Interval funds* would allow shareholders to redeem shares at net asset values at fixed regular intervals.

The SEC staff is studying the accounting conventions that could be used to account for redeemed shares and the related amounts payable between the time orders are received and the time payments are made.

SEC Proposed Amendments to Forms N-1A and N-2

In 1991, the SEC proposed amendments to Forms N-1A (for open-end funds) and N-2 (for closed-end funds). Generally, the proposals focus on discussion of fund performance, disclosures relating to portfolio managers, and revisions to the per-share table on which auditors must report for certain periods. These amendments are presently awaiting the SEC's consideration.

Regulatory Concerns

The staff of the SEC Investment Management Division has noted, in various public forums, the following matters that frequently give rise to comments on materials filed with the Commission:

1. Mutual funds sometimes enter into so-called "soft-dollar arrangements" whereby certain goods and services are provided to the funds and paid for by third parties in the form of brokerage services. At a minimum, goods and services paid for by third parties under brokerage arrangements should be disclosed in the fee table prescribed by item 2 of Form N-1A and item 3 of Forms N-3 and N-4 and on the face of the statement of operations.
2. Rule 12b-1 of the Investment Company Act of 1940 permits funds to incur expenses for the distribution of their shares in certain circumstances. Some distribution arrangements require funds to reimburse third parties for distribution costs that they incur. Funds should evaluate the need to report contingencies or liabilities incurred pursuant to such plans in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*
3. Concentrations of credit risk arising from relationships between parties providing credit enhancements to multiple security issues held in the investment portfolio should be considered for disclosure in accordance with FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.*
4. Mutual funds sometimes charge the costs incurred to merge or restructure open-end funds into dual- or multiple-class funds, which issue more than one class of common stock, to capital or record them as deferred charges. In most cases, such costs do not meet the definition of an asset in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements,* and therefore should be charged to expense as incurred.

Audit Issues and Developments

Audit Issues

Valuation of Securities. The issue of valuation of investment securities remains a prime concern for auditors of investment companies. The purchase and redemption prices of fund shares is based almost exclusively on the value of a fund's investment portfolio. Investment securities whose disposition is restricted under federal securities laws and securities trading in illiquid markets require additional scrutiny to ensure that carrying value approximates fair value. To the extent that the values are determined by the board of directors, supporting documentation should be reviewed and evaluated.

The AICPA Audit and Accounting Guide *Audits of Investment Companies* includes guidance on testing portfolio valuations, including estimates of value as determined in good faith by boards of directors.

Multiple-Class Funds. Multiple-class funds are those that issue more than one class of shares. The number of such funds has increased significantly in recent years. Such funds must allocate income, expenses, and distributions among the multiple classes of shares.

In obtaining the understanding of the internal control structure required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* auditors should consider whether management has implemented procedures for allocating such funds' income, expenses, realized and unrealized gains, and distributions to the multiple classes of shares. Auditors should also consider the adequacy of disclosures in the financial statements relating to the multiple classes of shares.

Before approving multiple-class arrangements, the SEC staff requires a letter from experts, generally the funds' independent auditors, reporting on the initial design of the internal control structure relative to allocating earnings, determining dividends, and calculating net asset value per share. Furthermore, on an ongoing basis, a report on the design and testing of the internal control structure may be required to be issued.

Hub and Spoket. An investment structure, commonly referred to as a master trust or a Hub and Spoket, permits a number of funds (spokes) with similar investment objectives to invest in a single limited partnership (hub). That structure may enable smaller funds to achieve economies of scale while the limited partnership hub passes through to the spokes the character of income generated. For publicly held spokes, the SEC staff currently requires financial statements of the hub to be filed with each spoke's financial statements.

Audit Developments

COSO Report on Internal Control. In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework.* The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management's reporting on internal controls over financial reporting.

The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting to External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help in evaluating an internal control system.

The four-volume set (No. 990002CL) costs $50; the "Executive Summary" (No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department (see order information on page 13).

Attestation Standards. The Auditing Standards Board has exposed for comment a proposed Statement on Standards for Attestation Engagements (SSAE), *Reporting on an Entity's Internal Control Structure Over Financial Reporting.* This statement, which would supersede SAS No. 30, *Reporting on Internal Accounting Control,* addresses engagements in which a CPA examines and reports on management's written assertion about the effectiveness of an entity's internal control structure for financial reporting. A final Statement is expected to be issued in the first quarter of 1993. Form N-SAR requires a report on the internal control structure of an investment company A sample report that auditors might use is included in the Audit and Accounting Guide *Audits of Investment Companies.* Reports prepared to meet the requirements of Form N-SAR are exempted from the scope of the proposed SSAE.

Accounting Developments

FASB Pronouncements

Fair Value of Financial Instruments. In December 1991, the FASB issued Statement No. 107, *Disclosures about Fair Value of Financial Instruments.* The Statement requires disclosure of the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, the Statement requires disclosure of descriptive information pertinent to estimating the fair value of a financial instrument. Certain financial instruments (for example, lease contracts, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement. FASB Statement No. 107 is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets in the current statement of financial position. For those entities, the effective date is for fiscal years ending after December 15, 1995. *Audit Risk Alert—1992* includes further discussion of the provisions of FASB Statement No. 107 and its audit implications.

Although investment companies already report most of their financial instruments at fair value in the financial statements, their auditors should be alert to the fact that FASB Statement No. 107 also requires that a description of how such values are determined be presented in the financial statements.

Right of Setoff. In March 1992, the FASB issued Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.* The interpretation defines *right of setoff,* as used in Accounting Principles Board Opinion No. 10 and FASB Statement No. 105, and specifies what conditions must be met to have that right. It also addresses the applicability of the general offsetting principle to forward, interest-rate swap, currency swap, option, and other conditional or exchange contracts and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement. The interpretation is effective for financial statements issued for periods beginning after December 15, 1993.

Income Taxes. In February 1992, the FASB issued Statement No. 109, *Accounting for Income Taxes,* which establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset-and-liability approach for financial accounting and reporting for income taxes. FASB Statement No. 109 supersedes FASB Statement No. 96, *Accounting for Income Taxes,* and amends or supersedes other accounting pronouncements (see appendix D of FASB Statement No. 109). FASB Statement No. 109 is effective for fiscal years beginning after December 15, 1992, with earlier application encouraged. Although investment companies usually do not incur federal income tax liabilities, auditors should be aware that FASB Statement No. 109 applies to all income taxes, including those that may be levied, by states or other jurisdictions, on funds failing to qualify as a Regulated Investment Company under subchapter M of the Code and on funds failing to distribute substantially all of their taxable income.

Consensus of the FASB's Emerging Issues Task Force

In Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions,* the FASB's Emerging Issues Task Force (EITF) discussed whether accounting for complex options and similar instruments should be guided by FASB Statement No. 52, *Foreign Currency Translation,* EITF Issue No. 90-17, *Hedging Foreign Currency Risks with Purchased Options,* or some other approach. At its November 21, 1991, meeting, the EITF reached a consensus requiring certain footnote disclosures about the method of accounting for, the nature of, the hedging period for, and the amount of gains and losses on complex options and similar transactions. At the EITF's March 1992 meeting, the SEC observer stated that the SEC staff will object to deferral of realized or unrealized gains or losses contemplated within the scope of Issue No. 91-4 for hedges of anticipated, but not firmly committed, foreign-currency transactions. The FASB's current project on hedge accounting will likely address the issues raised and no further EITF discussion is planned.

Accounting Standards Executive Committee Activities

Return-of-Capital Reporting. The AICPA's Accounting Standards Executive Committee (AcSEC) has approved for final issuance, subject to clearance by the FASB, a proposed Statement of Position (SOP), *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies,* which provides guidance on financial reporting by investment companies for distributions to shareholders, including returns of capital. The proposed SOP recommends that, to avoid shareholder confusion, the term *return of capital* should be used to report only portions of shareholders' distributions that are treated as returns of capital for federal income-tax purposes. A final SOP is expected to be issued in late 1992, and to be effective for financial statements for fiscal years beginning after December 15, 1992, and interim statements for periods in such years.

High-Yield Bonds. AcSEC has approved for final issuance, subject to clearance by the FASB, a proposed SOP, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies,* on reporting high-yield debt securities held as investments. The proposed SOP recommends—

1. Using the effective-interest method to report interest income on payment-in-kind bonds and step bonds.
2. Writing off interest receivable on defaulted high-yield securities when realization becomes doubtful, in accordance with FASB Statement No. 5, *Accounting for Contingencies,* and allocating the write-off between income (for the portion that had been recognized as income) and the cost of the related investment (for the portion purchased).
3. Reporting capital infusions in support of defaulted debt securities as additions to cost; reporting workout expenditures as realized losses only to the extent that they are incurred as part of negotiating the terms and requirements of capital infusions or are expected to result in a plan of reorganization; and treating as operating expenses ongoing expenditures to protect or enhance an investment or expenditures incurred to pursue other claims or legal actions.

4. Procedures to be considered by auditors for reviewing the valuations of high-yield debt securities to be reported in financial statements.

A final SOP is expected to be issued in late 1992 and to be effective for financial statements for fiscal years beginning after December 15, 1992, and interim statements for periods in such years.

Reporting Foreign Exchange Gains and Losses. AcSEC expects to consider for final issuance a proposed SOP, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies,* for computing and reporting foreign-currency gains and losses under generally accepted accounting principles for funds that (1) invest in securities denominated or expected to settle in currencies other than U.S. dollars, (2) invest in currencies other than the U.S. dollar, or (3) have foreign-currency transactions. The proposed SOP would amend the AICPA Audit and Accounting Guide *Audits of Investment Companies* to require consistent classification of all foreign-currency gains and losses as components of realized or unrealized gain or loss on investments. It also recommends a uniform way for separately reporting realized and unrealized foreign-currency gains and losses for those who choose to do so. The audit and accounting guide expresses no preference for reporting separately the portion of realized gains and losses on investments that result from foreign-currency rate changes and the change in the market value of the investments.

The FASB and AcSEC must evaluate the SOP prior to issuance. The final SOP is expected to be issued in late 1992 or early 1993.

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This Audit Risk Alert supersedes *Investment Companies Industry Developments—1991.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1992,* which was printed in the November 1992 issue of the *CPA Letter.*

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 862-4272. Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.